



STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS

Draft

Date Amended:	09/07/01	Bill No:	AB 593
Tax:	Sales and Use	Author:	Diaz
Board Position:	Support	Related Bills:	

## BILL SUMMARY

This bill would, among other things, exempt from the 5 percent state sales and use tax, computer and computer peripheral equipment, as defined, purchased by new establishments engaged in software development for use in developing and manufacturing software.

## ANALYSIS

### Current Law

Under existing law, a sales tax is imposed on retailers for the privilege of selling tangible personal property in this state. The use tax is imposed on the storage, use, or other consumption in this state of tangible personal property purchased. Either the sales tax or the use tax applies with respect to all sales or purchases of tangible personal property, unless that property is specifically exempted.

Existing law, Section 6377 of the Sales and Use Tax Law, provides an exemption from the 5 percent state sales and use tax, for the sale and purchase of any tangible personal property purchased for use in a new manufacturing business, as defined, which is:

- (1) used by a qualified person, as defined, primarily in any stage of manufacturing, processing, refining, recycling or fabricating, or
- (2) primarily used in research and development by a qualified person, or
- (3) primarily used to maintain, repair, measure or test any property described in (1) or (2), or
- (4) sold to or purchased by a contractor for use in performance of a construction contract with a qualified person, as specified.

The Sales and Use Tax Law also currently provides some exemptions related to the computer industry. For example, Section 6010.9 provides an exemption for charges in connection with the sale of custom computer programs. In addition, the existing 5

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position*

percent manufacturing exemption contained in Section 6377 applies to any computer and computer software used or required to operate, control, regulate, or maintain property used in manufacturing.

### **Proposed Law**

This bill would amend Section 6377 of the Sales and Use Tax Law to:

1. Include within the 5 percent manufacturers' exemption, the sale or purchase of computers and computer peripheral equipment for use by a qualified person in those lines of business described in Standard Industrial Codes (SIC) 7371 (computer programming services), 7372 (prepackaged software) and 7373 (computer integrated systems design).
2. Define computers and computer peripheral equipment by cross-referencing Section 168(l)(2)(B) of the Internal Revenue Code that is tangible personal property as defined in Section 1245(a) of that code that is used primarily to develop or manufacture software.
3. Extend the conditional repeal date of the exemption to January 1, 2008 or any January 1 thereafter if certain employment figures fall below a specified amount.
4. Become operative on the first day of the first calendar quarter commencing more than 90 days after the bill becomes law.

### **Background**

Similar bills have been introduced in previous legislative sessions to expand the manufacturing exemption to the computer software industry:

AB 1063 (1997, Lempert, et al.), which was substantially similar to this measure and also had a corresponding income tax credit for existing software development establishments, was amended in the Senate Revenue and Taxation Committee to delete the sales and use tax provisions. This measure was later amended to delete the income tax provisions. The Board voted to support this measure.

AB 2661 (1996, Alpert), which was substantially similar to AB 1063 above, was held in the Senate Appropriations Committee.

### **COMMENTS**

1. **Sponsor and purpose.** This bill is sponsored by Governor Gray Davis in an attempt to extend the existing partial sales and use tax exemption for new manufacturers to new software developers, as these entities were inadvertently omitted from the bill that created the original manufacturers' partial sales and use tax exemption.

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position*

2. **The September 7, 2001 amendments delete superfluous language.** The previous version of the bill contained specific requirements for the type of software that needed to be developed in order for the computers and equipment to qualify for the proposed exemption. This language was essentially unnecessary and restrictive, and was therefore stricken from the bill.
3. **The May 9, 2001 amendments extend the sunset date until January 1, 2008.** Section 6377 currently contains a sunset date of January 1, 2001 or the next January 1 thereafter if certain employment figures are not obtained. The amendments extend the conditional sunset date for an additional 7 years.
4. **How far should the current exemption for manufacturers be extended?** Since the original manufacturers' exemption was created in 1993, there have been a variety of measures before the Legislature to broaden that exemption to other segments of industry, such as agricultural, biopharmaceutical, and teleproduction activities. Admittedly, there are numerous borderline activities between manufacturing and other divisions of the classification system. There are some manufacturing-type activities performed by establishments, such as manufacture of software, that are covered in other divisions under the current classification system and consequently, do not fall within the current language of the exemption. Should all these borderline industries be included?

## **COST ESTIMATE**

Administrative costs would be incurred in preparing and mailing a notice to taxpayers, and personnel time attributable to approving claimed exemptions, manually reviewing exemptions claimed on returns, amending Board regulations, and answering inquiries. An estimate of these costs is pending.

## **REVENUE ESTIMATE**

Based on expenditure data compiled by the Bureau of the Census, estimated 2002 purchases of computers and peripheral equipment by all California software developers will be about \$456 million.

This bill applies to new businesses only. Although there are no data that identify the portion of the above amount attributable to new businesses, that portion is likely to be fairly small. (This would be consistent with the Board's experience with the sales tax exemption for new manufacturers enacted in 1993.) If one assumes that new businesses comprise only 1 to 5 percent of the total expenditures, then exempt purchases would be \$4.56 million to \$22.8 million annually.

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position*

**Revenue Summary**

The estimated annual loss on sales of \$4.56 million to \$22.8 million is as follows:

State loss (5%)*	\$228,000 - \$1,140,000
------------------	-------------------------

\* While the state tax rate is 4.75 percent for calendar year 2001, it is assumed the tax rate will return to 5.0 percent in 2002.

Analysis prepared by:	Sheila T. Sarem	445-6579	09/20/01
Revenue estimate by:	Dave Hayes	445-0840	
Contact:	Margaret S. Shedd	322-2376	

sf

*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position*